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Fixed Investment Trusts--Some Observations

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FIXED INVESTMENT TRUSTS — SOME OBSERVATIONS

ONE of the most startling developments in the financial history of the United States has taken place in the last three years. The world has been in the stock market. The financial page is carefully studied on the street corners. The tabloids run tip columns. The public wants stocks; the public must have stocks; and, in one form or another, the public gets stocks. Whether the Great Break of October 28th and 29th has dulled this appetite remains to be seen.

Necessarily the conventional mode of obtaining new capital has changed. Bond issues are not popular unless a convertible feature is added, the company paying a correspondingly low amount of interest, and the purchaser obtaining the gamble (conservative or otherwise) he demands. Preferred stock is often brought out with the attraction of additional participation in earnings or else is made convertible into the more speculative common stock. Such developments mean new problems for the lawyer and additional grist to his mill, but even so, the salient problems, new perhaps to this generation, have been considered before. The territory is not entirely virgin ground; there are at least some precedents that can be resurrected, dusted off, revamped and introduced to care for the emergency.

During this same period,—and probably due to the all-consuming desire of the moneyed public, no matter how conservative, to get aboard the bull market—investment trusts (so-called) have become a vital factor. These are of two main types, the management trust and the fixed trust.

The fixed investment trust, sometimes called "contractual" trusts, some of the problems of which are discussed in this paper, must not be confused with managerial or speculative trusts, sometimes called "statutory" trusts, long known in the United States and originally imported from England. Such organizations, although commonly designated "investment trusts," are formed for the purpose of concentrating large capital under one management with broad discretionary powers, which, in the present highly developed form, permits wide diversification and constant change of investment with unlimited opportunities for speculative "trading," rather than true investment. And, indeed, the modern development, rather than choosing a true *trust* as the vehicle of operation, seems to be toward the corporate structure. Especially is this true in the state of New York, where, probably because of some doubt as to the applicability and operation of the rule against restraints on alienation, the corporate form has been, to the best of the writer's observation, the sole form. A corporation can readily be organized for this purpose by the inclusion of wide powers pertaining to the purchase, holding and sale of the securities of other corporations and by a proper intra-corporate structure. Such organizations, whether true trusts or trading corporations, are usually frank to admit that their *raison d'etre* is speculation on a tremendous scale, the success of which depends entirely upon the ability of the Board of Directors and the Management in the speculative field. Such organizations are as good as their management,—and no better. Whether they are a power for good or evil is beyond the scope of this paper. Their success cannot be denied.

Characteristics and Administration of Fixed Trusts.

The Fixed Investment Trust is entirely different. As its name implies, it is fixed; there is no opportunity for change in underlying securities except in specific emergencies, described in the trust indenture with great detail. The vehicle chosen is invariably that of the true trust set-up. Its future in no way depends upon its management for it has no management similar to that of the speculative organization. Its strength is that of its underlying securities and in proper administration of the fixed portfolio by the trustee pursuant to the terms of the trust agreement. It is not a speculation, and, in the opinion of the writer, it bids fair to win a place among the popular and leading classes of pure investment. It offers the investor a participating ownership in a carefully selected group of common stocks, chosen for their dividend record, their earning capacity, and their general soundness [1] from which he is led to expect a reasonable return and modest appreciation. The fixed investment trust seems to have become fully established as a permanent feature in American finance, —sufficiently so to warrant an examination into some of the problems that confront the attorney to whom is entrusted the task of constructing the machinery necessary to reach the required result and to provide proper administration after organization. The writer does not delude himself into the belief that he will present the solution of these problems. Some of them, particularly those respecting taxation, can only be definitely closed by the decision of the proper court of last resort; others will find solution in legislation before the courts have had an opportunity to act. The scheme of the fixed trust is believed to be new. Certainly it has developed into something definitely American; unlike the managerial trusts or trading companies, nothing exactly like the present device can be found prior to the present decade. According to one authority [2] the present form as commonly used is a variation of an

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[1] The sponsors of North American Trust Shares have demonstrated to the writer that no stock was considered eligible for the portfolio of that successful enterprise unless (a) it had paid consecutive dividends for at least thirteen years, (b) was rated A or better by Moody, (c) was listed on the New York Stock Exchange, and (d) otherwise fitted in with the trust's scheme of diversification and generally contributed to the soundness of the resulting security as an investment. Other trusts have contented themselves with the leading companies in a given industry. *Cf.* Bank Stock Trust Shares; Insuranshares Trust Certificates; Automotive Participation Shares. Some have even specialized in a group within an industry. *Cf.* Trustee Standard Oilshares, the portfolio of which is made up entirely from stocks of the so-called Standard Oil group of companies.

It should be needless to say that reference to a given security anywhere in this paper has no relation to its strength or weakness as an investment. Nor is there any intention to praise or criticize. The writer is an attorney; let the shoemaker stick to his last.

[2] Robinson, Investment Trust Organization and Management, 1926, p. 264 *et seq.* Mr. Robinson refers to the Fixed Investment Trust variously as "banker's share" companies; and "trustee certificate" companies. They are

old idea to which resort was originally had to permit the purchase of high-priced stocks by means of splitting up the beneficial ownership and the sale of participating certificates in conveniently small denominations. By this means one was enabled to purchase indirectly as little as one one-hundredth of a share of the stock of a company such as the Ford Motor Company of Canada, Ltd. A similar organization of great interest was the "London, Midland & Scottish Trust." [3] These trusts are reported to have received considerable adverse criticism because of improper sales methods, unwarranted profit to the sponsors and corresponding expense to the investor.

The transition from one stock to several was but a short step. The resulting wide diversification and correspondingly increased safety, as well as the introduction of fair treatment of the investor, and the application of open business methods, have removed most of the grounds for criticism. Naturally every activity harbors its black sheep, but the fact remains that at this writing no less than twenty trusts of this type can be found listed in the "Over the Counter" section of the *New York Sun* [4] representing an enormous public participation.[5]

A fixed investment trust is normally created by the execution of an agreement of trust to which the trustee, the depositor and the beneficiaries are parties,—the latter by virtue of taking and holding the certificates by which the beneficial interest is represented. The depositor is the settlor of the trust. It is a corporation formed usually with powers not dissimilar to those of a trading corporation, for the purpose of purchasing the securities underlying the trust and depositing them with the trustee. The trust agreement is quite elabor-

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treated in a chapter entitled "Stock Conversion Companies." Mr. Robinson states, "In this chapter we shall study an application of certain investment trust principles in form peculiar to the United States." The 1929 edition of Mr. Robinson's book was published too late to be consulted.

[3] Robinson, *op. cit.*, p. 267.

[4] See *The New York Sun*, September 24, 1929. The list is obviously but a partial enumeration of the trusts actually in business.

[5] An accurate estimate of the total investment in fixed trusts is not available. As of October 15, 1929, North American Trust Shares had disposed of $29,000,000 in certificates since February, 1929. Trustee Standard Oilshares, on the same date, had outstanding over $12,000,000 in something over fourteen months, $10,000,000 of which were sold since May, 1929.

ate, defining all essential elements of the trust, including not only the duties, powers and immunities of each of the parties, but also containing carefully constructed provisions respecting the trust property.

The fundamental unit of beneficial interest is called a "trust share" [6] and is usually given a name or title, fanciful or otherwise, by which the security becomes known and around which the good will of the trust is constructed.[7] The trust share represents an undivided fractional interest in the trust property. It is rarely given a nominal or par value, although some instances have come to the attention of the writer. The size of the fractional interest depends to a large extent, *ab initio* at least, upon the price at which the security is intended to be sold. This price is made up, in every case, by the actual market value of the underlying securities, plus odd lot brokerage, plus the reserve fund (if any) and accumulations, plus a small charge, say five to ten per cent, for profit. Seldom do these trusts first appear on the market at a price in excess of ten to fifteen dollars per trust share. The shares are represented by certificates of various denominations running from five or ten shares to as high as ten thousand. The certificates may be either registered or in bearer form; if the latter, they are intended to be transferable by delivery merely, in the same manner as a negotiable instrument, and contain elaborate contractual provisions tending to make the instrument negotiable in fact if not in law. The certificates contain upon their face an appropriate legend, referring to the trust agreement under which they are issued, together with a summation of the more important provisions respecting negotiation by delivery, termination of the trust, etc. Attached to each certificate, if in bearer form, are appropriate coupons, calling for semi-annual payments to be made in the manner subsequently more fully described. All in all

[6] Also "trust certificates," "participation certificates," or any other appropriate designation.

[7] Undoubtedly the law of unfair competition will afford protection in a proper case to the name adopted by the trust. This field is not confined to investment trusts and is outside the scope of this paper. As a matter of interest, Standard Oilshares, Inc., Depositor of Trustee Standard Oilshares is the complainant in a Delaware action now pending, seeking to restrain Standard Oil Group, Inc. from the use of its corporate name and the name "Standard Oil Trust Shares" as applied to a similar trust.

such certificates are not unlike a bond in general appearance. On the reverse of each coupon is printed an ownership certificate for purposes of Federal Income Tax.[8] On the reverse of the certificates appears a list of the underlying securities as of a certain date, usually the date of the creation of the trust.

The process by which trust shares are created is as follows: At the time of the execution of the agreement, the depositor, having made the necessary purchase, deposits with the trustee a "stock unit," as fully described in the trust agreement, and consisting of a certain number (say four) of shares of each of the common stocks [9] of a number of carefully chosen companies. The designation of these companies, as a practical matter, is most important. The entire success of the trust depends upon an intelligent and industrious examination and analysis of numerous companies and the final choice of sound and progressive concerns with an assured dividend policy as well as a proper and satisfactory record and growth.

In addition to the stock unit, there is also deposited with the trustee certain cash, representing dividends, etc., payable subsequent to the deposit to stockholders of record prior to the deposit. In some trusts there is also deposited a given amount of cash as a reserve fund, the purpose of which is to stabilize distributions.[10] It is provided in the agreement that all income received by the trustee is to be credited to "currently distributable funds"; which funds are to be paid out entirely to the stockholders semi-annually against coupons above mentioned, or in case of registered certificates, by check to the registered owner. Where a reserve fund is provided, each semi-annual coupon calls for a definite amount—say 30¢ per share.[11] If currently distributable funds at a given coupon date are in excess of this amount, not only is the 30¢ paid but the full amount of the excess is distributed at the

[8] The trustee of a true trust of this type must make a fiduciary return. The ownership certificate is to supply the necessary information respecting the beneficiary for whose account the payment is made.

[9] Or, of course, any other type of security.

[10] *Cf.* North American Trust Shares and Fixed Trust Shares.

[11] If there is no reserve fund, the amount of the coupon cannot be definite. In such cases it calls for the payment of the "appropriate proportionate part" of the trust income. *Cf.* Trustee Standard Oilshares.

same time, the certificate holder receiving his proportionate share of all income received by the trustee. If, however, the amount available for distribution is less than 30¢, the trustee makes up the difference out of the reserve fund, so that, as long as there are funds in the reserve, the shareholder will receive as a minimum the amount called for on the face of his coupon. If the reserve fund has been depleted by a given distribution, then the next time there are currently distributable funds in excess of 30¢ per share, the trustee withholds [12] an amount sufficient to replenish the reserve fund—but only out of the excess—and distributes the balance.

Upon the deposit, as above described, of a stock unit and cash, the trustee issues to the depositor certificates representing trust shares comprising a unit as agreed upon in the trust agreement—say 2,000—each share thus representing an undivided one two-thousandth of a unit of deposited property which would be worth, if the value of the stock unit plus the cash was about $20,000, in the neighborhood of $10 each.

The agreement also provides that at any time and from time to time new deposits may be made of stock units and cash, against each of which certificates representing a similar number of trust shares will be issued. Provision is made in the case of the cash accompanying each deposit for the inclusion of all accumulations on the property already in the trust to the end that every unit deposited will be exactly the same as every other unit and thus every trust share will be exactly the same as every other trust share, making one large trust rather than a series of separate trusts, with corresponding ease in marketability of the shares and in bookkeeping mechanics. It is apparent that with this machinery there is no limit to the size to which a trust of this type may grow.

The duration of the trust is commonly twenty years or longer. At its termination the trustee will liquidate the deposited property and distribute the cash *pro rata* to the holders of the shares. In order that there will be no sudden flooding of the securities market with large quantities of the

[12] To keep the question of income taxation clear the agreement provides that the necessary amount will be paid to the Trustee or the Trustee may withhold it from the total payment. This makes it certain that the full amount of the coupon payment is income to the shareholder irrespective of the amount withheld.

stocks held in the trust the trustee should be permitted a reasonable time within which to liquidate—say three months or longer. Incidentally, the writer has heard black prophecies as to the dire effect of such liquidation upon the market. Consider, they say, one hundred millions in stocks that *must* be turned into cash. But a trust of one hundred millions means, at present prices, about twenty thousand shares of a given security. This number is but a small fraction of the normal floating supply and should be absorbed by the market over a period of three months with hardly noticeable effect.

Validity of Fixed Trusts in Respect of Perpetuities.

The trust as drawn in New York is created for a definite period of years.[13] The agreement contains, however, provisions by which it may be terminated prior to that time by the trustee and, furthermore, provisions by means of which the holders of trust shares may surrender their shares, terminate their own interest in the trust and receive from the trustee the value thereof.[14] It is these provisions which save the trust created in the state of New York from the operation of the New York rule against restraints on alienation.[15] It is provided in the Personal Property Law as follows:

> "The absolute ownership of personal property shall not be suspended by any limitation or condition, for a longer period than during the continuance and until the termination of not more than two lives in being at the date of the instrument containing such limitation or condition. * * *"[16]

[13] In jurisdictions recognizing the English view of the Rule against Perpetuities, the period is indefinite, phrased as twenty-one years after the death of certain named individuals.

[14] In case a holder of shares constituting a unit wishes to surrender, he may receive from the trustee a unit of the deposited property in kind, together with the cash in the reserve fund and in the currently distributable fund applicable to such unit.

[15] More properly so called rather than "rule against perpetuities." It is not truly a rule against perpetuities. See the Liberty National Bank case, *infra* Note 22 at 494; Hammerstein v. Equitable Trust Co., 156 App. Div. 644 at 652, 141 Supp. 1065 (1st Dept., 1913).

[16] New York Personal Property Law (1917), Sec. 11.

It is well established in New York that a trust for a fixed period, no matter how short, violates the rule against restraints on alienation since the rule is based upon a life or lives in being.[17] And it is, of course, upon this ground that any question of illegality would be raised. There is, however, an additional provision in the statute which is as follows:

> "In other respects limitations of future or contingent interests in personal property are subject to the rules prescribed in relation to future estates in real property." [18]

The Real Property Law contains the following definition of the suspension of the power of alienation:

> "The absolute power of alienation is suspended, when there are no persons in being by whom an absolute fee in possession can be conveyed." [19]

A preliminary question is this—Does the provision of the Personal Property Law incorporate the quoted provision of the Real Property Law for this purpose? There are apparently no decided cases in which this section was specifically incorporated, but generally most of the real property rules have been assimilated [20] and it seems to be a reasonably safe assumption, if not certain law, that such is the case with the provision above cited. In Williams v. Montgomery [21] it is so

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[17] Philips v. Pond, 23 N. Y. 69 (1861). *In re* Kalter's Will, 86 Misc. 621, 148 N. Y. Supp. 921 (1914); Davis v. MacMahon, 161 App. Div. 458, 146 N. Y. Supp. 657 (1st Dept., 1914), *aff'd* 214 N. Y. 614, 108 N. E. 1092 (1915).

[18] *Supra* Note 16.

[19] New York Real Property Law (1917), Sec. 42.

[20] See National Park Bank v. Billings, 144 App. Div. 536, 129 N. Y. Supp. 846 (1st Dept., 1911), *aff'd* 203 N. Y. 556, 96 N. E. 1122 (1911). The cases in which this gradual assimilation has taken place are too numerous for citation. A few of the more important are as follows: "Vested" and "contingent future" estates in personal property are defined as similar estates in real estate. Vanderpool v. Burke, 63 Misc. 545, 118 N. Y. Supp. 548 (1909). The rule that an unqualified gift of the income from real estate is in legal effect a devise of the property itself is applicable to a similar gift of income of personal property. Tabernacle Baptist Church v. Fifth Ave., Baptist Church, 60 App. Div. 327, 70 N. Y. Supp. 181 (1st Dept., 1901), *aff'd* 172 N. Y. 598, 64 N. E. 1126 (1902). An excellent collection of authorities may be found in McKinney's Consolidated Laws of New York, Annotated, Personal Property Law, pp. 16, 17.

[21] 148 N. Y. 519, 526, 43 N. E. 57 (1896).

stated and the same result has been clearly indicated in a strong *dictum* by the United States District Court of Massachusetts, in Liberty National Bank, etc. v. New England Investors' Shares, Inc.[22]

If the New York rule against restraints on alienation is to be interpreted pursuant to the authorities above discussed (and it is hard to avoid such conclusion), it is submitted to be conclusive for the legality of the trust that the provisions of the agreement permit the holders of trust shares representing a unit [23] of deposited property to terminate their interest in the trust and receive the underlying securities, cash, etc. since there are at all times persons in being entitled to receive absolute title to the property held in trust and with it the complete power of alienation. It should make no difference whether the power thus to terminate the *entire* trust is in the hands of one person or several.[24] It seems safe to assert

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[22] 25 Fed. (2d), 493, 496 (D. C. Mass., 1920). This case involved a fixed investment trust much as above described. Since the settlor company was incorporated in Massachusetts, the decision turned upon an interpretation of the law of the settlor's domicile under which the trust was held valid in respect of the rule against perpetuities. The Court added, however, a strong dictum to the effect that even if the New York law was held to apply, the attack upon the trust under Section 11 of the Personal Property Law would also fail. The Court said: "* * * there were provisions, in the trust under consideration, by which a holder or holders of 1,000 collateral trustee shares could, at any time during the life of the trust, surrender his, or their, certificate or certificates representing the shares and receive a unit of underlying securities in exchange therefor. These provisions bring the case within the principle enunciated in Hammerstein v. Equitable Trust Co., *supra*, inasmuch as at all times it was possible for the holders of the beneficial interest to terminate the trust as to that portion of the trust *res* represented by their shares and thereby acquire the absolute ownership and power of alienation over the same. The result would be the same whether the trust was terminated by the acts of one party or by the joint acts of several parties." The Hammerstein case, referred to in the foregoing quotation, was affirmed, but the point involved here was not discussed. See 209 N. Y. 429; 103 N. E. 706 (1913). For authorities in other jurisdictions on this saving feature see Groub v. Blish, 152 N. E. 609 (Ind. App., 1926); Baker v. Stern, 216 N. W. 147 (Wis., 1927); Howe v. Morse, 174 Mass. 491, 55 N. E. 213 (1899).

[23] It need not, of course, be a unit. In the indenture by which North American Trust Shares are created, the holders of shares representing a quarter unit or any multiple thereof may so terminate. This agreement requires the deposit of four shares of each stock in a unit and contains provisions which assure that there will never be more or less than four shares of a given security, by requiring the sale of stock dividends and split-ups of all shares received in excess of four. Unless these latter provisions are contained in the indenture, the portfolio soon becomes unbalanced and mechanical details for the taking down of less than a unit are practically impossible.

[24] See Williams v. Montgomery, *supra* Note 21; Stoiber v. Stoiber, 40 App. Div. 156, 160; 57 N. Y. Supp. 916 (2nd Dept., 1899).

that such trusts are valid under the New York Law. To make assurance doubly sure a number of trusts have provisions in the agreement enabling the holder of any number of shares, no matter how few, to surrender their certificates and receive the cash value of their shares. This is made practical by the depositor maintaining with the trustee a sort of revolving fund. An amount of money approximating the value of a unit is set aside and expended in taking up small shareholdings when presented. When a unit has so been purchased, the shares are turned in and a unit property is taken out of the trust and sold, the proceeds being used to replenish the revolving fund.

Income Taxation of Fixed Trusts Under the Federal Statutes

Section 701 (2) of the Revenue Act of 1928 reads as follows:

> "The term 'corporation' includes associations, joint stock companies and insurance companies."

Prior revenue acts contained identical language.[25] Under this statutory definition an important question arises as to the taxation of a fixed investment trust operating along the lines hereinbefore discussed—Is the income received by the trustee [26] upon the underlying securities and other property, to be distributed by it to the holders of the trust shares, taxable at the rate prescribed for corporations and payable only by the trustee as an "association," or is it to be treated as a true or "pure" trust, and the tax paid by the beneficiary who ultimately receives the income? [27]

In order to approach this question properly, attention must be called to the type of organization commonly referred

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[25] Section 2 (2) of the Revenue Acts of 1926, 1924, 1921, 1918, 1917.

[26] The indenture provides that the trustee shall have legal title to the deposited property and that securities shall be held in its name or in the name of its nominees. Dividends, etc., on the deposited stocks are paid to the holders of the securities.

[27] In general, the beneficiaries return, and are taxed on, income which is distributed; the trustee returns, and is taxed on, income which is accumulated. Art. 861 of Regulations 74.

to as a "Massachusetts Trust,"—usually a collection of capital under a deed of trust in which the trustee administers the property for the benefit of numerous beneficiaries whose equitable interest is represented by transferable participating shares much the same as certificates of stock.[28] Indeed the declarations of trust by which these organizations are created are artfully designed to bring about nearly all corporate advantages without actual incorporation.[29] The true nature of these organizations has been the core of much litigation since their introduction in Massachusetts from England in the early nineteenth century, but gradually a classification has been developed which has resulted in their being either (1) trusteeships or pure trusts on one hand, or (2) partnerships on the other—and into which class a given organization will fall is determined simply by the amount of control retained by or given to the beneficiaries.[30] No authority has been found in this connection, *i.e.*, the classification into trusts or partnerships—where the question presented was income tax liability.

The Treasury Department was thus faced with an organization, often very large both as to capital and as to number of beneficiaries, which, under the law of the state in which it was organized, would be held either a trust or a partnership. Whether it be treated as the one or the other, the Government would receive a tax based upon the rates for individuals, which have always been lower than those placed upon corporations. Furthermore, corporations were not permitted many of the deductions and other advantages extended to individ-

[28] There is no reason why the "Massachusetts Trust" structure could not be used for a managerial or speculative type of investment trust. Indeed it would seem that the original importation from England of this type of organization was in just this form. In New York the development is along corporate lines. See *supra* p. 2.

[29] Warren, Corporate Advantages Without Incorporation, 383 *et seq.* See the Declaration of Trust of the Boston Personal Property Trust printed in Warren, *op. cit.* 880. The Mackay Companies, operating the Postal Telegraph and Commercial Cables is another outstanding example of this type of organization.

[30] 8 Thompson, Corporations (3rd ed.), Sec. 6737. This is the test adopted in Massachusetts. See Williams v. Milton, 215 Mass. 1, 102 N. E. 355 (1913) (the leading case in that state), and Bourchard v. First Peoples Trust, 253 Mass. 351, 148 N. E. 895 (1925).

uals. They are subject to a tax on the issue of their stock [31] and at one time they were taxed upon dividends received from other corporations.[32]

Adopting the policy of collecting the most possible tax and letting the taxpayer fight out the question of a refund in the courts, the Treasury Department proceeded to impose a tax upon these organizations as associations under the statutory definition above set out. A favorable opportunity presented itself in the case of a Maine corporation which had transferred to trustees, stock held by it in a paper manufacturing corporation in Massachusetts, together with certain real property held by the Massachusetts corporation as lessee. This transfer was made under a declaration of trust which gave wide powers to the trustees, reserving to the beneficiaries (the interests of whom were represented by transferable shares) only the power to consent as a condition to the increase of the compensation of the trustees, the filling of any vacancies among trustees, or modifying the terms of the trust. Under the Revenue Act of 1913, the Treasury Department held this organization to be an association and assessed and levied a tax against the trustees upon dividends received by them. The trustees took the position that they were strictly trustees and entitled to exemption as individuals.[33] Suit was instituted and eventually the now famous decision of Crocker v. Malley [34] was handed down by the Supreme Court of the United States. The court practically conceded that the organization would be held a true trust under the laws of Massachusetts [35] and proceeded to determine whether a different view was required by the Revenue Act under consideration. The court held the organization not taxable as an association.

[31] U. S. Code, Sec. 901. The tax on the issuance of capital stock is shown in par. 2 of Schedule A annexed to said section.

[32] Under the Revenue Acts of 1913 and 1916. To-day dividends received by a corporation are permitted as a deduction from gross income. See Revenue Act of 1928, Sec. 23 (p).

[33] See Revenue Act, 1913, Sec. 11 (d).

[34] 249 U. S. 223, 39 Sup. Ct. Rep. 270 (1918).

[35] *Ibid.* 232, 39 Sup. Ct. Rep. at 271: "There can be little doubt that in Massachusetts this arrangement would be held to create a trust and nothing more."

Students of tax avoidance were thus presented with a decision of the United States Supreme Court on a question of Federal taxation, to the effect that a true trust (being such under the law of the place of its organization by virtue of almost complete lack of control in the beneficiaries) was not an "association" under the Revenue Act. This, coupled with the fact that the doctrine of the Crocker case was applied literally by the Treasury Department, resulted in a mushroom growth of organizations of the Massachusetts Trust type, with carefully drawn declarations of trust to exclude control by the beneficiaries to assure that under the state law applicable, they would be held pure trusts. This was a favored method of tax avoidance.[36]

Although nearly all of the Massachusetts Trusts were engaged in some kind of business enterprise, it will be noted that the trustees in the Crocker case did not "carry on business." [37] This differentiation between the character of the trust in the Crocker case and in large numbers of organizations seeking to come within its rule was soon the basis for a second attempt on the part of the Bureau of Internal Revenue successfully to tax these large aggregations of capital, carrying on business in much the same manner as corporations.[38] The renewed effort on the part of the Treasury Department resulted in the decision by the Supreme Court of

[36] Not, it will be noticed, tax evasion. It is apprehended that no policy of the law compels one to conduct his affairs so as to pay the most possible tax. While the law should frown upon an attempt to evade taxes properly due, one is entitled, legally and equitably, to avoid payment of unnecessary taxes. The only question presented is whether the means used are legally effective to accomplish the result. See Bowers v. New York Trust Company, 9 F. (2d) 548, (C. C. A., 2nd, 1925) for an excellent example of avoidance as distinguished from evasion. Generally on the subject see U. S. v. Isham, 17 Wall (U. S.) 496, 506 (1873); Weeks v. Sibley, 269 Fed. 155 (D. C. Tex., 1920); Draper v. Hatfield, 124 Mass. 53 (1877) and *cf.* Morris v. Gelmer, 129 U. S. 315, 9 Sup. Ct. Rep. 289 (1889); Young v. Pollak, 85 Ala. 439, 5 So. 279 (1888).

[37] In the words of Mr. Justice Holmes, they did not "manage the mills." *Supra* Note 34 at 232, 39 Sup. Ct. Rep. at 271.

[38] Nearly every advantage of corporate organization can be obtained by a careful preparation of the Declaration of Trust. It may obtain succession of members, ownership of property, concentration of powers of management, suits by or against the entity, elimination of liability of shareholders and trustees,—as to the latter at least to the extent of claims based on contract. The small risk as to liability for tort claims is the only situation where complete analogy to corporate organization cannot positively be obtained. Warren, *op. cit., supra* Note 29 at 383 *et seq.*

the United States in Hecht v. Malley.[39] The Hecht case consisted of three actions for the refund of excise taxes assessed under the Revenue Acts of 1916 and 1918 against three different "Massachusetts Trusts,"—the Hecht Real Estate Trust, the Haymarket Trust and the Crocker Trust. The Hecht trust ran an office building, the Haymarket trust ran a store and office building, and the Crocker trust ran cotton mills.[40] In the case of each organization, it was held that an association had been created, taxable as if a corporation, the Court saying: [41]

> "We think that the word 'association' as used in the Act clearly includes 'Massachusetts Trusts' such as those herein involved, having quasi-corporate organizations under which they are engaged in carrying on business enterprises.[42] What other form of 'association,' if any, it includes, we need not, and do not, determine."

The Crocker case was distinguished and confined to its specific result, namely, that the Income Tax Act of 1913 did not show an intention to impose upon trustees, as an association, double liability as to dividends on stock of a corporation that itself paid a tax.[43] The Court added:

> "* * * And the language used arguendo in reaching this conclusion that the trustees could not be deemed an association unless all trustees with discretionary powers are such, and that there was no ground for grouping together the beneficiaries and trustees in order to turn them into an association—is to be read in the light of the trust agreement there in-

[39] 265 U. S. 144, 44 Sup. Ct. Rep. 462, 68 L. ed. 949 (1924).

[40] The Crocker Trust conceded its classification as an association. *Ibid.* 157, 44 Sup. Ct. Rep. at 466.

[41] *Ibid.* 157, 44 Sup. Ct. Rep. at 466.

[42] The Court subtends a footnote at this point as follows: "In the present cases the Circuit Court of Appeals said: 'It is a matter of common knowledge that, for most business and financial purposes, all the larger organizations of this sort have for years been indistinguishable from corporations. * * *' 281 Fed. at p. 370."

[43] *Supra* Note 39 at 160, 44 Sup. Ct. Rep. at 468.

volved, under which the trustees were, in substance, merely holding property for the collection of the income and its distribution among the beneficiaries, and were not engaged, either by themselves or in connection with the beneficiaries, in carrying on any business." [44]

Before proceeding, certain features of these decisions should be emphasized. Crocker v. Malley, although including in its reasoning the thought that to call the trust there involved an association would be "an unnatural perversion of a well-known institution of the law," [45] a perversion, in other words, of the institution recognized by the law as a trust, only decided that if double taxation results, and it is not clear that such result was intended, then an organization will not be taxed as an association.[46] The Hecht case involved no question of double taxation, since all that was to be determined was whether the trusts there involved should pay an excise tax. Either that tax was to be paid or there would be no tax. Further, the Court did not stop to decide whether or not these trusts were true trusts or partnerships. In either case, they would be associations under the applicable Revenue Act.

This last position of the Court was challenged in a later case—Burk-Waggoner Oil Association v. Hopkins.[47] There the plaintiff was organized to carry on business in the State of Texas. It was founded upon an agreement called "articles of association" and its capital was divided into transferable shares. There was, however, considerable control left to the shareholders, making it certain that, under the Texas law, the organization would clearly be considered a partnership.[48] Here, for the first time since Crocker v. Malley, the Supreme Court of the United States passed upon the question of "asso-

[44] *Ibid.* 161, 44 Sup. Ct. Rep. at 468.

[45] *Supra* Note 34 at 234, 39 Sup. Ct. Rep. at 272.

[46] The opinion of Mr. Justice Holmes contains the following sentence: "Upon the whole case we are of opinion that the statute fails to show a clear intent to subject the dividends on the Massachusetts corporation's stock to the extra tax imposed by G (a)."

[47] 269 U. S. 110, 46 Sup. Ct. Rep. 48, 70 L. ed. 183 (1925).

[48] *Cf.* Thompson v. Schmitt, 115 Tex. 53, 274 S. W. 554 (1925).

ciation" in respect of income taxation [49] in a situation where (unlike the Hecht case) there were provisions for income taxation ready to be applied regardless of which classification was adopted for the organization. The direct question was whether the tax was properly imposed upon the organization as an "association," and, therefore, as if it were a corporation.

The argument made by the plaintiff was not unlike that in Crocker v. Malley—double taxation. Further, although the Act referred generally to associations, it also referred, and referred specifically, to partnerships. Admitting that had only an "association" been taxed that plaintiff would be held such, nevertheless there was also specific reference to a partnership, into which classification plaintiff fell by the law of the state in which it was organized and in which it conducted all of its business. If it was a partnership in that state (claimed the plaintiff), then the question was settled—it was a partnership for all purposes, including Federal income tax. To all of which the Court answered as follows:

> "The term partnership as used in these sections obviously refers only to ordinary partnerships. Unincorporated joint stock associations, although technically partnerships under the law of many states, are not in common parlance referred to as such." [50]

Crocker v. Malley was not cited.

Here, then, we have a holding that irrespective of whether a given organization is a partnership under the law of the state of its organization, it may, nevertheless, be an association for the purpose of taxation under the various Revenue Acts, and, further, that the definition of association to include a corporation applies to all sections of the entire Revenue Act, whether they cover excise tax, income tax or what not.

This decision, it will be noted, fixes the law as to partnerships. How then as to those organizations which are un-

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[49] Had the excise tax been involved it would seem that Hecht v. Malley would be conclusive on the question in favor of the government.

[50] *Supra* Note 47 at 113, 46 Sup. Ct. Rep. at 49.

doubtedly trusts? It would seem to follow, by close analogy, that the same result would be reached,—admitting the organization to be a trust according to the law of the state where organized and where the business is conducted, nevertheless it may be an association under the Revenue Act.

The District Court of the United States for the District of Massachusetts has had this specific question before it twice since the Burk-Waggoner case was decided. In Hornblower v. White [51] a corporation, formed for the purpose of developing and irrigating land in Colorado, was in financial difficulties. The "Costilla Trust" was formed, to raise money for the payment of taxes and ultimately winding up its affairs. The trustees were to hold, control and manage the securities of the corporation "with full general powers, *inter alia,* to vote the shares and continue or discontinue the corporation, to foreclose or not, and generally to exercise their best judgment and discretion in taking such steps and measures as will insure the most prompt and efficient realization upon the values in the Costilla property, and a winding up of its affairs and the affairs of the Trust." [52] Certificates for shares representing the beneficial interests were issued. The question was soon presented whether the organization was subject to the stamp tax imposed by the Revenue Act of 1918 and the Revenue Act of 1921 on the issue of stock by a corporation. It was held that the organization was not an association and not subject to the tax in question, and this squarely upon the ground that, under the laws of Massachusetts, a pure trust had been formed.[53] Although decided long after the Burk-Waggoner case, that decision was not cited. Hecht v. Malley was cited but distinguished solely on the ground that in each of the trusts there involved, the beneficiaries had the supreme control—a factor which was not present in the case then at bar.

The Hornblower case was appealed, but pending that appeal the question was again presented to the same court in

[51] 21 F. (2d) 82 (D. C. Mass., 1927).

[52] This extract was taken from a circular sent to the stockholders of the corporation stating the purpose of the proposed trust.

[53] The Court said (*supra* Note 51 at 82): "Its organization was similar to that of the Wachusetts Real Estate Trust * * * involved in the case of Crocker v. Malley, 249 U. S. 223, which seems decisive of the case at bar."

Neal v. United States.[54] The organization there involved was also a true trust under the Massachusetts law, but the question involved the imposition of the capital stock tax. The trust had been organized to undertake and carry on "anywhere, any business, transaction or operation which an individual could legally undertake and carry on." District Judge Brewster was content to follow Judge Lowell in the Hornblower case. The Burk-Waggoner Oil case was cited but, together with Hecht v. Malley, was distinguished upon the ground that the organizations, in their nature, were different from the trust then under consideration.

As stated above the Hornblower case was appealed. The decision on the appeal[55] was one of affirmance—but the affirmance was only as to the result,—the Court pointing out that the taxability of the organization as an association no longer depends upon whether it is a strict trust under the law of the state where created. The Court said:

> "The measure of control over the trust vested in the beneficiaries, does not seem to be the determining factor, but rather whether the trustees are conducting a business for profit or gain. * * * The powers of the certificate holders and the effect of the trust deed—*i.e.*, whether it constitutes a partnership or a strict trust —are significant only as they tend to show whether what the interested parties did amounted to forming themselves into an association for carrying on a business enterprise in quasi-corporate form for profit or gain."[56]

With this definition before them—"carrying on a business enterprise in quasi-corporate form for profit or gain"—the Court proceeded to an examination of the trust and, reaching the conclusion that the activities of the trustees were only such as naturally followed from ownership of the securities which they held, decided that the organization was

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[54] 26 F. (2d) 708 (D. C. Mass., 1928).
[55] See 27 F. (2d) 777 (C. C. A., 1st, 1928), *sub. nom.* White v. Hornblower.
[56] *Ibid.* 778.

not carrying on a business and, therefore, in spite of its quasi-corporate form, was not taxable as an association.[57]

The decisions above discussed seem to be reducible to the following principles:

(1) An organization in trust form with quasi-corporate characteristics but which does not carry on a business, is not an association under the various Revenue acts. Crocker v. Malley, *supra.*

(2) Such an organization which does carry on business is an association. Hecht v. Malley, *supra.*

(3) An organization carrying on a business in quasi-corporate form is an association regardless of whether it is a partnership or a trust under the state law. Burk-Waggoner Oil Association v. Hopkins, *supra* (partnership), and White v. Hornblower, *supra* (trust).[58]

In order to make complete the résumé of the authorities respecting this matter, some mention should be made of the rulings within the department. A full discussion is outside the scope of this article, and, covering the authorities to the date of publication, has appeared in most satisfactory form elsewhere.[59] It is a fair summary to say that the decisions and rulings followed closely the lines laid down in the cases above discussed and have emphasized the question: Is the organization conducting business in a quasi-corporate form? If the answer is "Yes," it is held to be an association; if "No," then

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[57] The Neal case has also been appealed. In the opinion of the writer it will be reversed, since the trust was empowered to carry on a business. See text following the reference to this footnote. [N. B.: Since the foregoing was written, by a *per curiam* decision, and resting solely on the Hornblower case, *supra,* Neal v. United States was reversed. 28 F. (2d) 1022 (C. C. A., 1st, 1928).]

[58] The writer has not overlooked the fact that the decided cases relating to the determination of what constitutes an association have come up under varying types of taxes: capital stock tax, stock issue tax, income tax, etc. In answer to the possible argument that each case should not be extended beyond its actual holding, there is undoubtedly an indication in the Burk-Waggoner case that the Court will apply its rulings in this connection to all types of taxation. The Department has done this very thing. See Article 1314 of Regulations 74.

[59] See a booklet entitled Some Legal Questions in Relation to Investment Trusts, by Leonard M. Wallstein of the New York Bar, published in 1928 by The Corporation Trust Company.

it is taxed as a trust. And it seems settled that both of these elements must be present.[60]

There seems to be a great scarcity, both in the Department and in the courts, of authorities which deal with the taxation of either the fixed or managerial type of investment trust. General Counsel's Memorandum #1881,[61] involved a trust indenture under which the trustee was given power not only to direct and supervise investments, but also to sell and purchase any security held as part of the trust property. It was, therefore, truly a "management" or "speculative" trust —a trust organized for the purpose of deriving profit from the purchase and sale of securities rather than from cautious investment,—it was a trust organized to speculate and trade. Clearly such activities constitute carrying on a business and it is equally clear that the opinion of the General Counsel, taxing the organization as an association, was sound. The trust was organized as a typical "Massachusetts Trust" organization—a board of trustees, similar to the directors of a corporation and shares transferable on the books of the company, similar to corporate stock.

A second authority appears as a result of a request to the Department for a ruling by a trust which was organized similar to the typical fixed trust as described early in the paper. This ruling is signed by the Commissioner of Internal Revenue, and is dated January 15, 1929, bears the symbols GC:I:I:JA, and the number "A-230362." [62] Here the organization deposited units of property against which certificates were issued by the trustee representing beneficial ownership, and generally was built upon the accepted lines of the fixed trust. There were provisions in the trust indenture which permitted sale of the trust property under six different conditions—(1) if a deposited stock was split or divided,[63] (2)

[60] See G. C. M. 4120, VII—36 Cum. Bull. 3883, where the organization admittedly carried on a business enterprise (development of real estate subdivision) but was held taxable as a trust and not an association since, generally speaking, it was not organized in quasi-corporate form. And see G. C. M. 3412, VII—17 Cum. Bull. 3691 where, although in quasi-corporate form, the activities of the organization were said not to be a business enterprise. Here, too, a tax as a true trust was imposed.

[61] VII—1 Cum. Bull. 42.

[62] This ruling is in the form of a letter to the attorney for the organization to which the writer has been given access.

[63] For a discussion of this element see *infra* p. 26.

if a corporation, the stock of which was part of a unit, merged with another corporation, or reorganized,[64] (3) if such corporation should liquidate, or if a receiver should be appointed and the receivership continue for sixty days,[65] (4) if such corporation failed to pay dividends for one year,[66] (5) if the depositor believed that dividends would cease to be paid or if it thought any stock would become substantially impaired in value. (6) If any stock had a market value in excess of its average cost to the depositor.

The indenture also provided that the proceeds resulting from the sale might be reinvested by the depositor in similar property, or else distributed as the depositor directs.

Consider the result of the above powers of sale coupled with the power to reinvest. Particularly consider provisions 5 and 6 in this connection. If the depositor thought the stock was too high, or if there was a profit, then there could be a sale and a reinvestment. Clearly, it is submitted, the Commissioner of Internal Revenue was correct in rendering his opinion that the organization carried on *the business* of buying and selling securities for a profit, and, since it was organized in quasi-corporate form, it was, therefore, an association and taxable as if a corporation. Indeed, it is difficult for the writer to distinguish, in substance, this trust from the ordinary management trust with power to speculate. Probably the powers are equally wide with the possible exception of the ability to "sell short." The argument advanced by the organization that the sales and reinvestments were made for the sole purpose of protecting, safeguarding or improving the integrity of the original investment is not convincing. The fact remains that there was power to sell securities for the sole purpose of realizing a profit and also the power to reinvest, which, in its essentials, is the power to trade.[67] A trust with

[64] The right to *sell* the stock under these circumstances seems unusual in a trust of this type.

[65] Again the right to *sell* is uncommon. Usually, if not sold before the cessation of dividends, the proceeds are distributed to the certificate holders on the next distribution date.

[66] This is a usual provision, although perhaps the period is normally shorter. This arbitrary elimination of a stock which fails to produce a return seems desirable. See *infra* p. 25.

[67] It should be mentioned that the test is not what the organization *does*, but what it has *power to do*. See G. C. M. 5504, VIII—2 Cum. Bull. 4061, where an organization, upon being held an association, had ceased to do the

such wide powers of sale of property and reinvestment of proceeds seems properly held a business enterprise and taxable as an association if conducted in quasi-corporate form.

It might well be argued that such an organization is not quasi-corporate in character and should not, therefore, be taxed as an association, even though carrying on a business enterprise, since both elements must be present.[68] There is but one trustee, and nothing corresponding to the board of directors of a corporation.[69] In addition there is nothing corresponding to the meetings of a Board of Directors or stockholders, and, in the writer's opinion, the action of the individuals—stockholders and directors—back of the corporate entity *in meeting assembled* is one of the most significant characteristics of the corporate form. Further, there is the question of dividends. Corporate stockholders, even holders of a preferred stock carrying cumulative dividends, are entitled to dividends only when and as declared by the Board of Directors out of the surplus of the corporation. The indenture of a fixed investment trust, on the other hand, can and often does [70] provide for payments to the holders of the beneficial interests at fixed dates, irrespective of the wishes of the trustee and, what is more important, whether the payment constitutes a return of capital or not.[71] Unless the Department takes the position (as it may well do, pending a court decision on the question) that merely the division of the beneficial interest into transferable shares constitutes "quasi-corporate form," this line of argument might well be a fruitful line to follow.

Passing now to the question of the powers of the organization,—how far may the provisions of the trust indenture

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things indicated by the Department as constituting a business. When the tax was again imposed and protested the ruling held it to have been proper since the trust still retained the *power* to conduct a business enterprise, even if that power was not exercised. It appeared that the trust under consideration above had in fact exercised its powers of sale and reinvestment a number of times and that substantial profits had been realized.

[68] See Note 60, *supra.*

[69] But see G. C. M. 2405, VI—2 Cum. Bull. 10, holding that the fact of but one trustee does not prevent the organization from being an association.

[70] See, for instance, the trust indenture creating North American Trust Shares, on file at the office of Guaranty Trust Company of New York, Trustee.

[71] As in the case of a deficiency, payment out of the reserve to meet a coupon. See *supra* p. 6.

go in the direction of administration of the trust property and still fall short of the line between an association and a true trust? How far, in other words, may the property of the trust be "managed" and not constitute the carrying on of a "business enterprise"?

It is, of course, essential to permit of some circumstances under which trust property may be sold. For instance, rights are often issued by corporations to stockholders, enabling them to purchase additional stock, convertible bonds or other securities of the corporation at a price less than the market value. Such rights are valuable assets of the trust, but, if that value is to be preserved to the beneficiaries, they must either be exercised or sold prior to expiration. These trusts normally have no funds available, nor is there provision whereby such funds can be made available, for this purpose.[72] The alternative is that the rights be sold. Such is the common sense solution. The sale is not for the purpose of realizing a profit. It is not an instance of the purchase and sale of securities for profit. It is not carrying on a business, and, it is submitted, even if such sale is a sale of the corpus of the trust, it is not, without more, a basis for calling the organization an association.

Another example of the necessity for sale is when a corporation, the stock of which is part of a stock unit, declares a dividend in kind. It would be impossible to distribute the property thus received to the numerous beneficiaries. Here again common sense requires such property so received to be sold and the proceeds distributed to the beneficiaries.[73]

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[72] Funds could, of course, be made available for this purpose. The amount required in a given period would be uncertain, however, and proper machinery difficult, at first blush, to devise.

[73] Attention should be called to G. C. M. 3412, VII—1 Cum. Bull. 1349, where a trust holding the fee to lease oil lands and which merely received and paid over to beneficiaries the rents and royalties, was held a true trust. The opinion, however, was qualified by predicating the conclusion on the assumption that the rents and royalties were received by the trustee in cash, and adding that if it should appear that payment was made in the products which were the subject of the lease and if the trustee in selling them was engaged in carrying on a business, the trust would be taxed as an association. This may be the law if the payment in property and the sale of that property was the regular and customary way in which the terms of the lease were performed. Under such circumstances the regular sale of the products might well be deemed a business. But a dividend in kind would be an extremely rare thing, and the occasional sale would lack the continuity which would seem requisite in the idea of carrying on a business.

A very common provision in indentures creating fixed trusts requires any security in the portfolio to be sold upon failure to pay a regular dividend, and the continuation of a non-dividend paying policy over a certain period of time. Under such circumstances the security has shown itself unworthy of a place as a true investment and should arbitrarily be eliminated. But this feature should not be a basis for the claim that the trust carried on the business of trading in securities for profit. The stock *must* be sold, there is no discretion in the matter. It is as nearly automatic as practical.

So much for the common provisions, none of which seems sufficient, even when combined with all the others, for the claim that a business enterprise, and, therefore, an association, exists. Sales of *corpus* under strictly limited circumstances, for a purpose other than the realization of profit, should not be the basis for taxing the organization as a corporation.

An additional problem along these lines has been presented. No matter how strict the trust instrument is made in an effort to make the organization truly a "fixed trust" there are always circumstances beyond the control of anyone connected with the trust, which may lead to a change in the amount or character of the indulging securities. For instance, stock dividends often are declared, which result in an increase in the number of shares of that stock in the portfolio. A stock might be "split," which would have the same effect. A consolidation or a merger might occur, resulting in the elimination of a security or a substitution of a new security.

Some of the indentures under which fixed investment trusts are created pay no attention to these situations—merely providing that such stock dividends be taken into the trust, or, in the case of "split-ups" or exchanges, the new security be taken in the place of the old.[74] Under such circumstances nothing whatever occurs to question the pure trust status of the organization. There is, however, a practical objection to permitting such additions or exchanges. Great pains are originally taken in obtaining proper diversification of the unit investment at the time the trust is created.

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[74] See, for instance, the Indenture by which "Trustee Standard Oilshares" were created, on file at the Empire Trust Company, Trustee, New York City.

If stock dividends and splits are retained in the trust, too great a concentration appears in the securities thus affected, and the carefully constructed diversification becomes unbalanced.[75] A carefully drawn trust agreement will guard against such unbalancing by inserting provisions to assure that a certain number of shares of each security will be in the trust at all times—never more and never less. This is done by requiring that when the trustee receives shares in excess of the number originally in the trust by virtue of a stock dividend, or by virtue of a "split-up" of stock held, or by virtue of an exchange, the original number of shares shall be retained and the excess sold.[76] Care must be taken to provide that the proceeds of such sale are to be distributed to the holders of certificates at the next ensuing distribution date and not to be reinvested by the trust.[77] Should such reinvestment be permitted the trust may well be said to carry on a business, although even here, as in the case of the sale for the purpose of eliminating a non-dividend paying security, the sale is mandatory and not made for the purpose of realizing a profit, and is made pursuant to explicit directions in the trust agreement and without the exercise of discretion.

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[75] As a practical matter such lack of balance not only decreases the safety of the security in the eyes of the investing public, but an affirmative result may well be evidenced, in that Blue Sky Commissions might interfere. The writer has been reliably informed that the California Blue Sky Law administrators will not qualify an investment trust more than five per cent. of which is invested in one security. The accuracy of this statement has not been checked. To demonstrate this "unbalancing" of the portfolio, the sponsors of North American Trust Shares claim that if that trust had been established in 1922, comprising four shares each of 28 stocks, with an approximately even distribution of investment over the group, today there would be 21% in one security and 52% in six securities.

[76] Sometimes an exchange would result in the trust owning less than the original number of shares of a given security per unit. *Cf.* an exchange of one share of new stock for four shares of old; an exchange of two shares of a new corporation for five shares of the old corporation. If a trust wishes to keep the number of shares of each security divisible by four—as is the case of a trust permitting the holders of a quarter-unit to terminate and receive the underlying securities applicable to a quarter unit—the agreement should compel a sale if the number of shares is ever below four.

[77] The result is economically sound. The shareholder realizes on a certain portion of the appreciation of the underlying securities. Since cash returns on important stocks are 3% or less, appreciation must be utilized by the person requiring a 6% return for normal living expenses. If this policy is not approved by the individual who wants his appreciation to remain in the trust, let him reinvest this portion of his coupon return in additional shares, in this manner diversifying such appreciation over all of the underlying securities. North American Trust Shares permits this to be done without profit to the sponsors. The new shares may be purchased without the "spread."

The provisions respecting sale of *corpus* in the case of a passed dividend, in the case of rights, and in the case of a split-up or exchange and, in each instance, requiring a return of the proceeds to the holders of certificates, were recently before the Commissioner in a request for a ruling on the part of a large trust. It was ruled that the organization in question was not an association but "for income tax purposes a trust within the meaning of the several Revenue Acts, and should file returns accordingly." [78]

Summary of Income Taxation of Fixed Trusts.

If the trust is not to be classified as an association under the Revenue Acts and not to be taxed as a corporation, care must be taken that the beneficiaries, or holders of the trust shares, have no control over the trust. They should be limited under the trust agreement to the right to receive distributions of income and *corpus* and, at the termination of the trust, their proportionate share of the trust property, either in cash or in kind. They may consent to a modification of the trust agreement but should not be empowered to modify it themselves. They should not be permitted to choose or remove the trustee and should be expressly denied the right to vote or consent with respect to any of the deposited securities. There should be no provisions for meetings of the beneficiaries or any action to be taken or consent to be given by them individually or as a body, nor should the trust shares carry any voting rights whatever. To aid in the interpretation of the agreement it should expressly provide that the contention of the parties is to form a true trust and no other type of legal relation.[79]

In spite of the attitude of the department taken in respect of a certain similar trust [80] the writer will not admit that the organization, properly safeguarded, takes quasi-corporate form. If the trust agreement limits the trustee to

[78] See a letter to Hughes, Schurman & Dwight dated June 18, 1929, from the Commissioner. It bears the symbols IT-E-RR-WTL.

[79] Such a provision is not, of course, controlling. But its insertion can do no harm and such evidence as to intention of the parties to an agreement must have some psychological probative value.

[80] *Supra* Note 62.

holding the property, collecting and distributing the income derived, and to selling, under narrow circumstances, clearly defined, certain of the trust property in unusual contingencies and distributing the proceeds without the exercise of discretion, it is hard to say that the form, under which the trust is conducted, is anything approaching a corporation. Compare these narrow powers of the trustee with those of a Board of Directors. There is no power to "manage the affairs" of the trust similar to the management of the affairs of a corporation by its Board of Directors. The trustee has no control over the amount of the distribution; the full income must be paid out regardless of the wishes of the trustee or anyone else. Stockholders, on the other hand, are entitled to dividends only out of surplus or earnings and then only when and to the extent that the directors see fit to declare them, which the Board may or may not do, irrespective of the amount or existence of income of the corporation, or of whether the stock is or is not "preferred." Unlike a Board of Directors of a corporation, the trustee of a fixed trust may not create a surplus, incur obligations binding the trust property (except contracts of sale when sale is required), or change any security in which the trust property is invested. There are no officers, no "Board," no meetings, no votes in the beneficiaries and no removal or selection of a trustee by them. Furthermore, while there are few, if any, points of resemblance in the organization of a fixed trust to that of a corporation,[81] it is exactly similar to the structure of an ordinary trust wherein the trustee is empowered to hold property and is required to pay out the entire income periodically, irrespective of the wishes of the trustee. It is, it would seem, difficult to escape the conclusion that a fixed trust as ordinarily constituted is not organized in "quasi-corporate form."

But even if the trust is "quasi-corporate" in structure, still it is not an association if it does not carry on a business enterprise, and a business enterprise is not conducted unless the trust property may freely be sold and the proceeds of the sale reinvested in other securities. A truly fixed trust does not permit such sale and substitution, otherwise it would not

[81] The only real basis of resemblance is the aggregation of capital with participating interests represented by "shares."

be "fixed." Necessarily certain powers of sale of the *corpus* of the trust must be given, but if these are carefully limited by the trust agreement and discretion as to time, place and manner of the sale strictly curtailed, and if the proceeds must be distributed to the beneficiaries, the trust will not be carrying on a business enterprise, will not be subject to classification under the Revenue Act as an association, and will not be required to pay the corporate income tax. The trustee of a fixed trust must hold the property. It must collect the income. It must distribute the income. At the termination of the trust and occasionally during its life it must liquidate its holdings and distribute the proceeds in cash or in kind. Every trustee has at least these powers, and the exercise of them does not, it is submitted, constitute management of a business enterprise.

Fixed Trusts and Inheritance Taxation.

During recent years a great deal of attention has been focused upon the practical features of inheritance taxation. Various tax experts have instituted campaigns and publicity drives calling attention to the various inheritance tax laws of the several states and, by emphasizing the numerous statutes taxing non-residents upon property owned within the state, exhorting investments to be scrutinized with a view to minimizing the tribute to states other than of the decedent's residence. Numerous states, taxing non-residents on property owned within the state, include in such property stock of a domestic corporation. Thus a resident of New York owning stock in a Utah corporation must pay a tax to the latter state based upon the value of his shares before the certificate may legally be transferred. Numerous booklets and advertisements have warned the investor that his estate conceivably can be taxed in twenty-three or more states and have pointed that by a judicious selection of equally good investments chosen with an eye to the state of incorporation (under, of course, the watchful guidance of the tax expert) large sums of money could be saved to his descendants.

Before discussing the fixed trust in connection with a possible savings in such multiple inheritance taxation, it is well to analyze the true situation. Just how much likelihood is there of actually decreasing the total amount of inheritance taxes?

First of all let it be known that nine states impose no inheritance tax on intangible personal property owned by non-resident defendants. Stock in corporations organized in these states is, therefore, not taxed, and since the list includes two of the favorite states of incorporation [82] a vast number of securities are immediately freed from condemnation.

Next we must note that three states—Alabama, Florida and Nevada—as well as the District of Columbia, have no inheritance tax at all,—either on residents or non-residents.

Thirdly, a large group of the more important commercial states have adopted a so-called "reciprocity" provision, the substance of which is that if the state of the domicil of the decedent does not impose an inheritance tax upon a domicilian of the local state, the latter, in turn, will impose no tax upon this decedent. A state belonging to this reciprocal group thus does not tax residents of any other state in the group. In addition, with respect to corporate stock, these states do not tax descendants domiciled in either of the two groups just described. At the present writing this group is composed of no less than twenty-three states and new states are continually joining.[83]

But there is still another fact to consider, for, assuming that the taxation imposed upon an individual, unfortunate enough to die domiciled in one of the wayward states and owning no property in any of the states comprising the first two groups, could be materially cut down by judicious reinvestment, we have yet to reckon with the Federal Estate Tax.[84] The tax imposed upon all decedents by the Federal Government, although graduated, amounts to a substantial sum upon large estates. A provision was inserted obviously

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[82] Delaware and New Jersey. The complete list of such states as of October 15, 1929 is as follows: Colorado. Connecticut, Delaware, Massachusetts, New Jersey, Rhode Island, Tennessee, Vermont, Virginia.

[83] The list includes the important states of California, Indiana, Illinois, Michigan, New York, North Carolina and many others. Eleven were added in 1929. South Carolina will join the reciprocal group as of January 1, 1930.

[84] Revenue Act of 1926, Sec. 300 *et seq.* as amended by the Revenue Act of 1928.

intended to ease the burden of multiple taxation. It would be permitted, it was provided, to credit against the tax payable to the government the amount paid by the estate to all states, up to 80% of the estate tax.[85]

With this added feature in mind let us see the effect upon the efforts of a domicilian in one of the twelve states imposing a tax and not in the reciprocal group to decrease his inheritance taxes. He is able, we will say, to avoid taxes to outside states entirely. He probably will be astounded to know that his efforts have had no effect but to increase his Federal Estate Tax by exactly the same amount.[86] The complicated effect to reduce taxes has meant nothing. His executors will pour his money into one hopper instead of another. He has, it would seem, been chasing a will-o'-the-wisp.[87]

After the above effort to minimize the actual importance in dollars and cents of the multiple inheritance tax problem, we may return to our examination of fixed trusts, for these organizations at one time (and some of them continue) have stressed the point that an investment in such security solves the problem.

Consider for a moment the managerial trust, operating in corporate form. Here the "beneficiary" is a stockholder in a certain corporate entity. He is not concerned with the securities in which the funds of his corporation are invested.

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[85] Revenue Act of 1926, Sec. 301-b. An interesting sidelight is this: The government reckoned without the greed of the states, a number of which, fifteen, including New York, enacted an estate tax of their own the formula of which is as follows: Eighty per cent. of the Federal Estate Tax less all state taxes of every kind including the local inheritance tax. The result in the case of these states is that the government will receive no more than one-fifth of the amount it originally intended.

[86] If the state of domicil is one possessed of its own Estate Tax (*supra* Note 85) the result is similarly to increase that tax rather than the Federal Tax.

[87] This must be considered only as a generality. There must be instances, conceivable at least, where the total amount of the multiple taxes paid to states other than the state of domicil exceed 80% of the Federal Estate Tax. If these can be reduced, the reduction to 80% will be a saving. In addition small estates might pay multiple taxes and no Federal Estate Tax at all and any reduction would be a saving. Nor has the writer forgotten the red tape which must be untangled in order to obtain a transfer of stock in many states even though no tax need be paid. Such formalities are numerous, bothersome, expensive and often result in great delay. See an excellent treatment of these formalities in the current Inheritance Tax Service of Prentice-Hall, Inc. Could these be avoided something would be gained, but such gain cannot be reckoned in dollars and cents and it is on the pecuniary savings that emphasis is too often laid.

His estate is subject to tax [88] in the state of his domicile and in the state in which his corporation was organized—exactly as if he owned shares in any other corporation.

As for the transfer of the beneficial interests in fixed trusts the answer is not so clear. A large number of these trusts are located in New York, in which state the trust property is located, and we should consider first of all whether there is a tax on the transfer imposed in New York.

The Tax Law contains a provision which imposes a tax upon the transfer by a non-resident decedent of any property or any interest therein in trust or otherwise when the transfer is by will or intestate laws on

> "b. Shares of stock or certificates of interest of corporations organized under the laws of this state * * *, or of joint stock companies or associations organized under the laws of this state and including all dividends and rights to subscribe to the stock of such corporations, joint stock companies or associations. * * *" [89]

Note the use of the phrase "organized under the laws of this state." Assuming, for argument, that a fixed trust is an association [90] it must also be "organized under the laws" of New York if a transfer tax is to be imposed. This phrase should be interpreted to mean "organized under the statute" of the state of New York.[91] A fixed trust is not so organized, but depends, for its legality and existence, upon the common law of trusts. Since trust shares do not come under the statutory definition, and since, by elementary reasoning, only

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[88] The phrase "subject to tax" is used broadly—in the sense that the state in question has the authority to tax whether or not that authority is fully or partially exercised.

[89] New York Tax Law, Sec. 248.

[90] *Supra* pp. 27-29, showing a fixed trust not to be an association under the Federal Revenue Acts. The same result should be reached under the New York statutes. See People *ex rel.* Manila, etc. v. Knapp, 229 N. Y. 502, 128 N. E. 892 (1920).

[91] This result has been reached in the Supreme Court interpreting the phrase "organized under the laws of the United States or of any state * * *" See Eliot v. Freeman, 220 U. S. 178 (1910) holding a Massachusetts Trust not to be so organized. The Court said (p. 186): "The language of the act * * * imports an organization deriving power from statutory enactment."

those things may be taxed which are included, no tax need be paid in New York upon the transfer of certificates representing the trust shares.

A further question is presented in respect of the transfer by death of the underlying securities. It may be argued that the holder of the shares in a fixed trust is the owner, in equity, of a fraction of each of the underlying securities—a small fraction perhaps, but, nevertheless, it is his property and, when this interest passes upon his death, it is subject to the tax imposed by the laws of the states in which each of the underlying corporations was organized.[92]

In many circulars proffered by fixed trusts the statement is made that "for all practical purposes" the trust shares will not be subject to multiple inheritance taxes.[93] It is argued that there is no tender of the stock certificate for transfer in the state of incorporation and, consequently, there is no means of enforcing the law or collecting the tax even if the state had means of knowing that there had been a transfer by death of trust shares underlying which there was a local corporation. Such statements are probably true. One text-writer states that at a meeting of investment trust executives, the question was asked, "Does any one know whether a holder of contractual trust certificates has died?" [94] If the trust certificates are registered, the trustee knows. And if the certificates are in bearer form the executor or administrator knows. It is not an answer to the question to say that by owning trust certificates a tax can be evaded. The honest executor or administrator or trustee may well ask himself, "Does the law require this tax? If so, my duty requires it to be paid." And if the question is put to the lawyer, the ethics of his profession should compel him to frown upon an evasion of taxes at least to the extent that he gloats over a legal avoidance of taxes. Nor, it is submitted, is the argument strengthened by reference to cases showing that the state in question could not

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[92] Some corporations are incorporated in several different states. New York Central (a favorite in fixed trusts) is incorporated not only in New York, but also in Pennsylvania, Ohio, Michigan, Indiana, and Illinois. Should a tax be necessary in each state the complications are apparent.

[93] No particular reference is made to any circular for obvious reasons.

[94] Fowler, American Investment Trusts, p. 192.

enforce the tax unless there was something there, upon which it could base a status of "lienor in possession" [95] and to cases showing that tax laws of one state have no extra-territorial effect and cannot be enforced in another state under the due process clause.[96]

Furthermore, such a statement of the practical effect ignores the proclamations made by the taxing authorities of three states to the effect that such interests will be taxed.[97]

Authority in any way helpful has been found only in New York where there are some cases, reasonably analogous, holding that a non-resident beneficiary of a trust, the *corpus* of which is stock in a New York corporation, is not subject to the New York transfer tax on his interest. The reasoning is that the right of the beneficiary has no interest in the stock itself, but merely a chose in action to obtain the stock upon the liquidation of the trust and, therefore, there is no transfer of the stock of a New York corporation subject to tax.[98]

In its essence the question is this: Is the share of the beneficiary an equitable interest in the stock of the corporations underlying the trust, or has he merely a chose in action to obtain his interest upon the liquidation of the trust? In spite of the clearness of the reasoning of the New York cases, the writer is inclined to the view that an equitable ownership more closely follows the true facts. The trust is a trust of specific shares; it is a *fixed* trust. The interest of the beneficiary is an interest in specific shares which cannot normally be changed, rather than an interest in a fund which happens to be invested in those shares. It is believed that should the case come up, a court might logically adopt this line of thought in spite of the practical difficulties of enforce-

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[95] Frick v. Pennsylvania, 268 U. S. 473, 497, 45 Sup. Ct. Rep. 603, 69 L. ed. 1058 (1924).

[96] Maxwell v. Bugbee, 250 U. S. 525, 63 L. ed. 1124 (1919); Colorado v. Harbeck, 232 N. Y. 71, 133 N. E. 357 (1921).

[97] Georgia, Indiana, and New Mexico.

[98] *Cf. re* Phelps Estate, 181 App. Div. 82, 168 N. Y. Supp. 536 (1917), where the Court stated the only question to be whether the non-resident decedent "owned these particular shares or not." Since he did not, there was no tax.

ment and collection, as to which we should not be concerned.[99]

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The title of this paper was not idly chosen. It attempts, not a solution, but a discussion, of but a few of the many problems connected with the creation of a comparatively new type of financial structure. To consider them all—the questions, for instance, of state and federal stock transfer taxes, the questions relating to the agreements by which nationwide distribution of the trust shares is obtained, the questions of qualification under the many and varied Blue Sky Laws of the several states, and many others—would expand an humble paper to the proportions and dignity of a textbook—a work which is bound to make its appearance, for fixed trusts are here and are here to stay. The present effort makes no pretense of subtle reasoning or profound thinking. It must be taken for what it has been named—merely "Some Observations."

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[99] Even after deciding the interest of the beneficiary to be an equitable interest in specific property there is the secondary question: Does the tax statute tax equitable interests? Usually it does. See, for instance, the New York Tax Law, Sec. 248 (1b).

The State Tax Commission has ruled trust shares not taxable. See Wallstein, Some Legal Questions in Relation to Investment Trusts, published by the Corporation Trust Company, p. 26.